

## MEMORANDUM

**TO:** Board of Commissioners

**FROM:** Power Contract Negotiating Team (Carol Wardell; Joe Jarvis; Kurt Carlson; Debbie Litchfield; Kelly Boyd; Janet Jaspers; and Steve Fisher)

**RE:** Template Aspects of the Proposed Power Sales Agreement with Puget Sound Energy

**DATE:** January 3, 2006

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The Power Contract Negotiating Team (“Team”), Bill Doyle (bond counsel with Orrick Herrington) and Rick Stephens (power contract and financial transaction expert with Holland and Knight) strongly recommend that most of the terms of the proposed power sales agreement (“PSA”) with Puget Sound Energy (“PSE”) be considered “template” provisions for future PSAs for the sale of output based upon a “slice of the system.” The future PSAs should contain most of these terms for a number of overarching reasons including: maintaining the “contract principles” as discussed with the Board; alignment of interests among the District and purchasers; equity among all purchasers; administration of the contracts and associated invoices; and risk management by the District.

The essential provisions of the proposed PSA best serve the needs of the District. It is true that some purchasers may be concerned about some of the provisions particularly because of the flexibility afforded the District in operations, financing, and the payment of its capital and debt. This flexibility is exactly what the Team intended to provide to the District’s current and future Commissioners. It would be quite unworkable for the District to limit its financial and operational flexibility as to some purchasers but not others. The Team kept our eyes on the target which was the best interests of the District, not what some purchaser may or may not like. The terms are very reasonable in light of today’s energy markets.

The District should have a portfolio of power sales agreements to diversify risks and provide the ability to withstand varying business conditions. A significant amount of power should be sold through take or pay, slice of the system contracts in order to hedge against falling market prices, rising District costs and impaired output from the projects. In order for these contracts to produce these risk-hedging results, the contracts need to include essentially the same provisions.

As indicated in the attached diagram, the District’s portfolio of sales of power may include various pricing mechanisms. The cost-based, slice of the system contracts,

however, should all reflect the same provisions. Mixing concepts between categories makes them ineffectual.

As pointed out by our bond counsel, rating agencies will favor substantially similar, template-type contracts. If the contracts all are different, an adverse reaction by the rating agencies can be expected due to the increased complexity and issues associated with that concern.

A comment from District bond counsel, Bill Doyle, is descriptive on these points: “To negotiate separate and materially different agreements with individual purchasers invites chaos, conflict, litigation, administrative nightmares and other very bad things over the term of those agreements.”

Discussion of some of the basic provisions best illustrate these concepts. This memo will cross reference both sections of the proposed Power Sales Contract (provided to the Board on December 19, 2005) and the “Major Points” memo (provided to the Board on December 5, 2005).

### **GENERAL CATEGORIES OF THOSE PROVISIONS THAT SHOULD BE CONSIDERED TEMPLATE IN NATURE AND USED IN ALL COST-BASED CONTRACTS BETWEEN PURCHASERS AND THE DISTRICT**

We have attempted to list the concepts, and not each and every provision, that should be part of a template. There are many provisions (i.e., insurance; risk of loss; representations; disclaimer of warranties, etc.) that are also template provisions. But, the Team wanted to focus on the more important substantive concepts in this memo.

**Slice of the System and Take and/or Pay.** (Articles V and VI and Section 7.02 of the PSA and Section 3 of the memo). The concept of purchasing a percentage of output has historically been on a take and/or pay basis. That is, the purchaser is entitled to receive only the output that is actually produced, whatever that is, and has no claims for “lost” output, regardless of the reason. The slice-of-the-system power contracts are common in certain segments of the energy industry, including the municipal utility industry. Such contracts include provisions which require a purchaser to pay its percentage share of all costs of the projects, regardless of the output it actually receives. This is a very basic concept to the cost-based contracts and must be maintained in all such contracts. The District takes on much greater risk and should be paid a much greater amount to guarantee any particular amount of energy to be delivered. That risk may be appropriate for shorter term contracts based upon a market pricing as reflected in the attached diagram.

**Mandatory Step Up.** (Section 5.04 of the PSA and Section 11a of memo). In order to manage the District’s future risks associated with the cost-based contracts, the PSA includes a mandatory step up should a purchaser default. This provision requires that all purchasers under “Related Power Sales Agreements” step up to take their percentage share of the defaulting party’s output. Related Power Sales Agreements are

defined as those agreements designated by the District as containing similar terms and conditions. The step up share is taken on the same basis as the assuming purchaser's underlying contract, i.e., take or pay; pay all costs regardless of output generated; etc. The provision would fail to protect the District as intended and the District would be accepting the risk of defaulting parties if the terms of future contracts were not similar to the proposed PSA.

**Operational control; purchaser meetings; approvals; invoices.** (Article VI, VIII and X of the PSA and Sections 4 and 11d of the memo). The PSA clearly states that operational control remains with the District. The District agrees to listen to the purchasers' recommendations and provide information to the purchasers, but the District is not required to obtain purchasers' consent or approval for capital expenses, maintenance or any other operational decision. The template limits the purchaser meetings to twice per year. When the District invoices purchasers for costs, they have a specified time to review those invoices (3 years after receipt) and cannot make claims for mistakes or issues going further back in time. The District has the ability to make curtailment and decommissioning decisions. These provisions should ensure all cost-based purchasers will communicate among themselves and better coordinate with the District. This will obviously help the District keep administrative costs down. All of these provisions provide efficiency and consistency and recognize the District as the "master of its own house."

#### **Financial – Future Payments:**

**Working Capital.** (Section 7.01B of PSA and Section 9b of memo). The amount established - \$10M per project (in 2004 dollars) - is based upon a calculation as to the cash needs of the District to meet and pay operating expenses on an ongoing basis for a period of approximately three (3) months. As discussed, the billings are in "arrears" and the working capital fund covers costs that are then billed and paid after the fact by the purchasers. If any one purchaser does not pay its share, then there would be an inadequate cash balance in the working capital fund to pay operating expenses of the projects and cover the non-payment of bills.

**Net Costs.** (Section 7.01C and Appendix A of PSA and Section 10a and b of the memo). There is no "margin" built into the Net Costs calculation in this cost-based contract. The provision includes the ongoing operational and maintenance costs as well as financing costs for debt (both existing and that debt which will be later incurred). If one purchaser did not pay their share of the costs, the burden would fall upon the District and its customer/owners. The financing costs provisions utilize an "assumed debt service" methodology intended to provide certainty to the purchasers while preserving flexibility for the District in terms of its debt management, financing techniques and refundings. To depart from these provisions again would be contrary to the District's best interests and defeat the very purposes of the provisions.

**Coverage Fund.** (Section 7.01D of the PSA and Section 9c of the memo). This is a critical piece of the proposed PSA template in that it is necessary for the District to

demonstrate sufficient debt service coverage in connection with outstanding and future financings. A purchaser's failure to pay its share of this requirement would obviously result in a "shortage" within the fund that would have to be made up by the District. Such Coverage Fund is also important for providing greater assurance to the rating agencies and bondholders which in turn positively impacts the District's credit rating.

**Capital Recovery and Debt Reduction Charges.** (Sections 7.01F, G, H of the PSA and Sections 10 c, d and e of the memo). As stated above, these provisions are critical tools for the District in maintaining financial flexibility in the future. These provisions are also significant risk management tools, in that the District is able to increase or decrease its debt over the term of the contract (20 years for PSE) as the circumstances warrant. If one or two purchasers paid into this fund, but another did not, there would be a huge inequity between purchasers. Certainly, there would be no alignment of interests with respect to these funds. The purchaser not required to pay or a purchaser failing to make the payments would actually receive a windfall. Someone would have to "pick up" the portion of capital or debt not paid by that purchaser – that would seem to fall on the District and its customers/owners. Again, not requiring these provisions as part of the template for cost-based contracts is contrary to the best interests of the District and its customers/owners. Both of these items reflect a cost of operation; a cost that should be paid by all those purchasing output from the District.

**Transmission Agreement.** (Article II and Exhibit B of the PSA; Transmission Agreement; and Section 10g of the memo). The Transmission Agreement provides standard terms and conditions for the delivery of output over the District's Transmission System. Purchasers should be similarly situated with respect to transmission deliveries on the District's system. Transmission Points of Delivery may be different for various purchasers. However, the Transmission Points of Receipt, method for calculating charges and losses, service specifications, risk of loss, waiver of liability and other provisions should be the same for everyone. Alcoa may require some variations to include load following services and integration of their load into our control area; but the other aspects of the Transmission Agreement should remain the same for all users of the District's transmission system.

#### **GENERAL CATEGORIES OF PROVISIONS THAT COULD BE NEGOTIABLE AND NOT TREATED AS REQUIRED TEMPLATE PROVISIONS BUT SHOULD BE REFLECTED IN FUTURE CONTRACTS IN SOME FORM**

The following provisions in the PSA with Puget Sound Energy provide some flexibility in terms of how they are included in future power sales agreements. They should not, however, be considered to be "non-template" items. Each one has value to the District and its customer/owners and should be included in some form.

**Capacity Reservation Charge.** (Section 7.01A of the PSA and Section 8 of the memo). Puget agreed to pay \$89 Million as an upfront payment for the ability to receive power under the cost-based contract beginning in 2011. This was a negotiated number and could certainly change with another proposed counterparty. The Board may want to

consider the circumstances of a particular party, the timing of the agreement and other particular facts. However, on the other side of the issue, the Board should also be concerned with a “fairness” issue from a political standpoint. The payment of this charge can be made in forms other than cash upfront and/or could be partially offset by other economic or beneficial conditions. For example, a utility may be able to make a smaller upfront payment and then pay cash (over and above the costs as defined in the contract) over time. There may be a utility that has transmission or other consideration to “trade” for part of the upfront cash payment. There is also the concept of a guaranteed number of jobs or investment in Chelan County and increasing the local tax base that may offset some of the upfront payment.

**Debt Administration Fee.** (Section 7.01I of the PSA and Section 10f of the memo). This provision is intended to reflect the District’s high credit rating used to benefit the purchaser. We actually started out in negotiations with Puget Sound Energy with a “credit rating premium” which would result in an amount to be paid depending upon the difference between the purchaser’s credit rating and the District’s. PSE desired a different method to calculate the amount due and we settled on a set percentage of the outstanding debt that would be a fair estimation of the benefit provided to the purchaser. In the future, this should be a template item but the purchaser could choose between the formula in the PSE contract or a credit rating premium based upon a different calculation. So, there is some flexibility for negotiation with regard to this provision. But, it certainly should be considered an item for inclusion in all of the contracts.

**Prepayment Requirement.** (Section 7.01E of the PSA and Section 9a of the memo). This fund, paid upon the first project availability date in 2011, serves effectively as collateral for any missed payment of any kind (including operating and maintenance costs, Financing Costs; Transmission Charges). Another way to handle this would be to include a provision requiring the purchaser to post collateral (i.e., letter of credit, cash) if the District has reasonable grounds to be concerned about the purchaser’s creditworthiness. Obviously, the cash up front is most beneficial to the District, but this is one provision that could be changed to reflect the creditworthiness of the purchaser. The provision however certainly should not be deleted. It provides protection to the District and our customer/owners in the event of delinquent payments or non-payment. The District should have some form of collateral protection; otherwise, the District’s customer/owners are at risk.

**Use of Output by Purchaser.** (Section 5.03 of the PSA). The proposed PSA provides that the purchaser may use or resell the output sold to it. This provision certainly can and should be modified depending upon the purchaser. For example, a purchaser receiving output because they provide jobs or economic value to Chelan County should be restricted from reselling the output.